Firstlinks
a Morningstar company

Edition 446, 18 February 2022

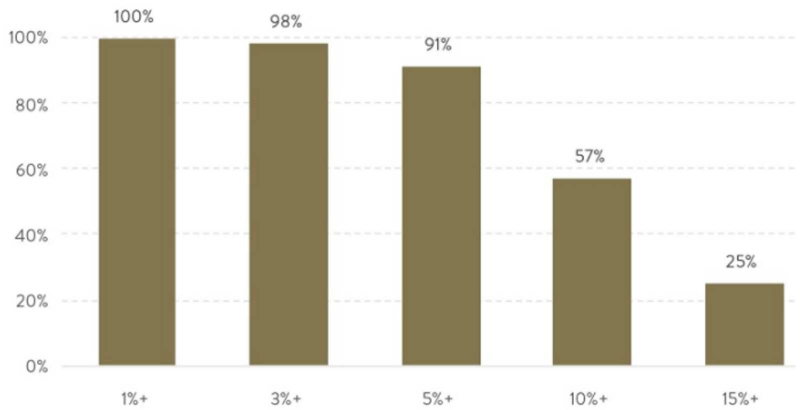
Contents

Editorial

After all the media exposure on Magellan and Hamish Douglass in recent weeks, including my interview, **Geraldine Doogue** asked me to discuss fund managers on her Saturday Extra programme on **ABC's Radio National**. She did not want to talk specifically about Hamish, but I thought the subject was something like, "How do you pick a good fund manager?" In fact, in her first question, she asked me, "What type of person is attracted to stock picking at this level?", which is different.

I've been rethinking the question ever since. My initial response was to quote the statistic that about 80% of large equity managers underperform their benchmarks over a long time period such as 10 years, and even the 'winners' in the 20% have a one-year period where they underperform, and 85% do so over a three-year period. My first point was that a fund manager must be resilient and consistent and able to withstand and explain long periods of failing to deliver.

Percentage of top-performing funds over 10 years that underperformed over any 12-month period and by how much



Source: Morningstar, Baird Analysis

An investor joining the fund at the wrong time might experience many poor years and give up before the fund manager can recover. This was explained in more detail by **Andrew Mitchell of Ophir** almost a year ago, and more than half of these top fund managers underperform by a remarkable 10%+ over some 12-month period in the 10 years. Selecting a fund manager is a long-term decision.

There's another common trait in fund managers who I rate highly. They recognise a theme or trend early and back it. My first observation of this was the legendary **Greg Perry** when we both worked at **Colonial First State** when his early move into infrastructure and especially toll roads paid off handsomely. Good fund managers read widely, listen to new ideas, they are naturally curious, follow the science and find companies that will win from these trends.

According to the publication **Inc.**, writing on **Warren Buffett**:

"Buffett reportedly spends as much as six hours a day reading books. It may be a daunting prospect for most busy people, but if you're up to the task, the Oracle of Omaha advises that we 'read 500 pages every day'. He says that's how knowledge works - it builds up like compound interest."

Picking successful, long-term active managers who are worth their fees is not easy, but instead of listening for the the hot stock tips based on a short-term valuation, find the fund managers who look 10 years ahead and present a strong case why they are at the front of the curve. This is not an argument for active over passive, but rather, a core/satellite portfolio with index at the core and talented managers for extra kick and diversification.

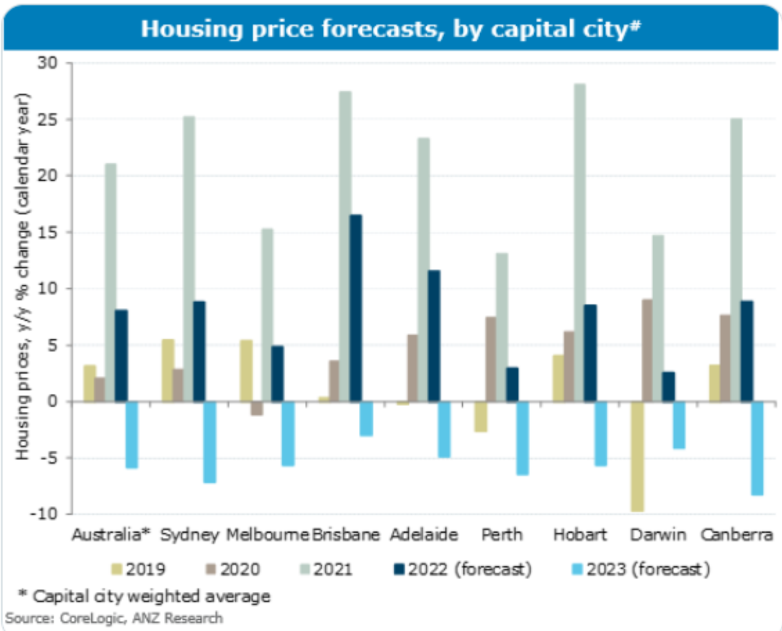
At the same **Morningstar Investor Conference**, two successful funds management businesses debated the relative merits of Listed Investment Companies. **Geoff Wilson of WAM** reminded us how much he loves LIC discounts, but it was good to hear **Chris Meyer of Pinnacle** put another view based on the **Antipodes** experience (and **Ellerston** and **Monash** have made the same arguments). Wilson and Meyer both identified the 'Holy Grail' of LICs, but they were not the same. Can they both be right?

In the current market facing the certainty of rising interest rates, it's tempting to sell rather than tough it out. For the first time in 40 years of writing memos to clients, **Howard Marks** addresses the sell decision. It's not only about timing the sale but when do you get back in for the recovery?

Geoff Warren continues this theme by asking about the role of cash. It's amazing how good cash looks when the market falls 10%, and it's plausible in 2022 that returns from other assets will be poor.

Now that our leading economists are moving their forecasts for the next cash rate increase to as early as June, only a few months away, the **Reserve Bank**'s view that rate rises would not come until 2024 looks like poor judgement. **Chris Bedingfield** examines house prices from another perspective, the supply and demand.

ANZ Bank released its forecasts yesterday and they expect a soft landing for house prices despite higher rates. The forecast is for up 8% in 2022 and down a modest 6% in 2023.



Still on property, I admit I can be a pain when it comes to friends and family asking my advice on investments. A mate told me last week that he was looking to buy an apartment in a holiday resort. One of the attractions is the ability to stay in the apartment when it is not rented out for short-term holidays. He said there was no point leaving money in the bank earning nothing and shares are too risky. This sounds like a scenario being considered by many readers looking for income in new places.

I'm sure he thought I would smile pleasantly and he would drive off to buy his dream with a view. Instead, I sent him this article from 2015. I have not changed the numbers so please read it knowing it is seven years old, but the arguments remain valid. These resorts are a crap shoot.

Adding to the potential headwinds for property, here is what **Gareth Aird** of **CBA Economics** said this week:

"We shift our central scenario for the first hike in the cash rate target to June 2022 (from August 2022). Our forecast profile now has the cash rate at 1.0% by end-2022 (a 15bp increase in June, followed by two 25bp increases in Q3 22 and a further 25bp in Q4 22). We expect one further 25bp rate hike in Q1 23 that takes the cash rate to 1.25% - our estimate of the neutral cash rate."

Firstlinks
a Morningstar company

Market volatility throws up opportunities, and **Gemma Dale** has looked at stocks which were at or near their 52-week lows at the time of writing. These stocks ran hard as the market recovered from COVID but then gave back a lot of their gains, and Gemma asks if they are now worth another look.

New research from the **University of Adelaide**, sponsored by the **SMSF Association**, sheds light on the appropriate size of SMSFs to be competitive with larger funds, and why diversification again proves its merit. Researchers believe the ATO data on SMSFs is increasingly unreliable for comparisons.

This week's White Paper from **Western Asset** looks at global inflation and highlights differences in recent inflationary impulses, expectations for inflation trajectories over the coming months and the potential implications for bond yields.

Finally, here's a quick summary of the changes in superannuation rules passed into legislation on 10 February 2022, all effective from 1 July 2022.

* Removal of the monthly salary minimum of $450 before an employee qualifies for the superannuation guarantee.
* Increase in amount of voluntary contributions that can be released from super under the First Home Super Saver Scheme from $30,000 to $50,000.
* Eligibility age for downsizer contributions allowing a contribution to super from the proceeds of selling a home decreased from 65 to 60.
* Increase in the cut-off age for the bring-forward rule applying to non-concessional contributions from 67 to 75.

There are also changes to the work test and exempt current pension income (ECPI) which are too complex to summarise here but will be covered in the near future.

How can the worst feature of LICs also be the best?

Graham Hand

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us ..."

- Charles Dickens, A Tale of Two Cities, 1859

The best thing about a mobile phone is that people can contact you at any time.
The worst thing about a mobile phone is that people can contact you at any time.

The best thing about Listed Investment Companies is that they trade at a discount to NTA.
The worst thing about Listed Investment Companies is that they trade at a discount to NTA.

Wait a minute! Is this the age of foolishness or the age or wisdom? Surely for LICs, it can't be both.

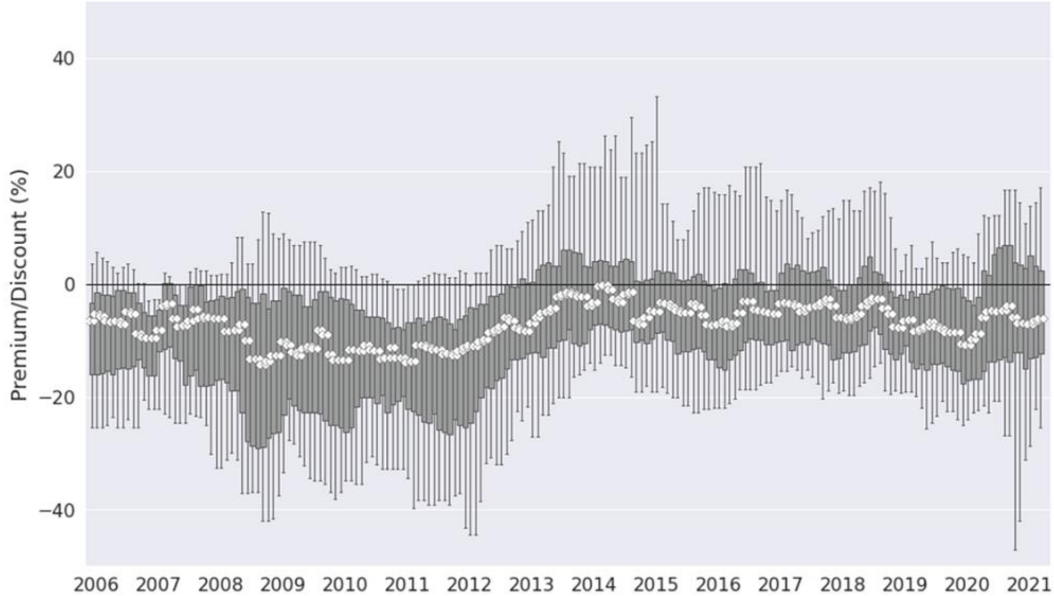
Well, that's what we were led to believe at the LIC session at the Morningstar Investor Conference last week by two leaders in the sector. Who was stretching incredulity, to use Dickens' word?

The worst of times

At the Conference, Michael Malseed of Morningstar showed the following chart of premiums and discounts for all Australian equity LICs back to 2006. The horizontal line in the middle is parity to the value of Net Tangible Assets (NTA) and the white dots show the median valuation. The discount is persistent but varies over time. The bars show the range of discounts and premiums across all LICs (longer bars are the 5th to the 95th percentile, fatter bars are the middle 50%).

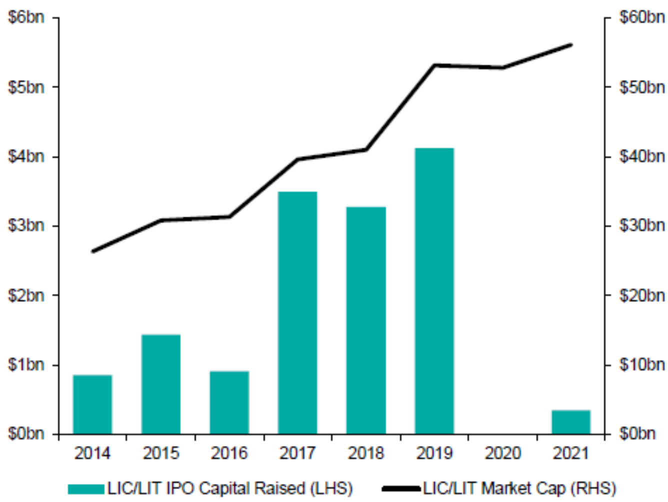
It highlights the main problem. Some LICs have so little investor support that they can sell for discounts of 40% or more. It's a disaster for an investor who supported the manager in the initial offer and now wants to sell, regardless of how the fund manager has performed.

Median and range of LIC share price premium/discount (in percentage terms) to NTA, across Australian equities LICs—2006-21



Source: Morningstar Direct. Data as of 31/10/2021.

The prevalence of discounts is one reason why new LICs have become almost non-existent following the ban on stamping fees paid by issuers to brokers and advisers. Firstlinks has already covered this subject in detail, [here]() and [here](). The ban effectively closed the IPO market in 2020. The main new transaction in 2021 was WAM Strategic Value (ASX:WAR) raising $225 million on the back of Geoff Wilson's strong direct-to-investor marketing with $125 million an entitlement allocation to existing shareholders.



Here are the LIC holdings of WAR picked up at decent discounts to NTA, including some of the most respected and highest-profile fund managers in Australia. It's not a good look for these managers. WAR itself is trading at a discount (end January NTA $1.26, share price $1.17). Anyone for a discount on a discount?

Attempts to remove the discount

Faced with persistent and embarrassing discounts, some fund managers have abandoned the LIC structure. Ellerston Global converted to an unlisted fund, Monash to an active ETF, Templeton Global Growth merged with Wilson Global and Antipodes converted to an ETMF.

Antipodes should have possessed the right ingredients for a listed vehicle to trade well. It was established by Jacob Mitchell in 2015 after 14 years at Platinum Asset Management and the team manages a healthy $8 billion. Yet after the first couple of years, its LIC could not remove the persistent discount, as high as 20%, even after buying back 13% of the company's shares.

Antipodes is part of the Pinnacle Investment Management group of boutiques, and at the Morningstar Conference, Chris Meyer, Director of Listed Investments at Pinnacle, said (edited transcript):

"Our journey with LICs started about five years ago with some strategies in global equities and Australian equities. One of the great things about listed funds, LICs included, is that you can click to buy them in an online broking account through your broker and it's very easy, whereas unlisted managed funds are quite cumbersome.

So we had demand from our client base to have a listed fund capability. We've since moved a little bit more into using the LIC structure to provide access for our clients to asset classes that they can't ordinarily access through unlisted managed funds or ETFs, such as private assets.

I think the Achilles heel for the sector, and we've had this for as long as it's been around, we definitely pick up some frustration amongst our shareholder base of our LICs and the advice market that they are frustrated with LICs. No one likes it when the share price and the NTA dislocates, particularly those that bought at IPO. And I do think we need to solve for that. I think we are on a journey to solve that, we are getting much better."

Pinnacle and Antipodes was willing to swap the guaranteed, committed capital of a LIC to an alternative where the money can be withdrawn by the investor to address this investor frustration. Malseed continued:

***MM**: Chris, I want to ask about your experience over 2021 of this consolidation phase with the Antipodes LIC. There were a number of options on the table to address the discount and you decided to give shareholders the opportunity to invest in the QMF (Quoted Managed Fund), AGX1. Can you talk about the pros and cons of what options there were on the table?*

***CM**: It comes back to discounts. There's a significant part of LIC discounts that are cyclical, because it depends on investor sentiment, it depends on investment performance, those things which ebb and flow in the history of the LIC industry.*

But there was also a potential that there is a different fund structure now which competes with LICs, which is the open-ended listed fund called the ETF. And I think it remains to be seen which of those two will win out. In the case of Antipodes, it was a five-year old company, for the first two years, it went gangbusters, great performance, traded at a premium, last three years traded at a discount particularly because it's a value manager and the markets weren't in its favour. It was underperforming the market. It was a big reason why the discount had widened up.

We tried everything, we did the ASX's biggest buyback, we put in a big effort on marketing and communication. But at the end of the day, we took the decision that we needed to do something in the best interest of shareholders. And we felt like giving them something that trades at its NTA and remove this perennial discount to NTA. And that's why we made the decision to move to an ETF.

Magellan obviously led the charge there in the beginning of last year with their High Conviction Fund, and we saw that as a pretty elegant solution. Antipodes already had an ETF and so now you can buy the same strategy from the same manager but you just no longer have the vagaries of premiums and discounts. The opportunity to buy at a discount is removed but it can also be a source of frustration and we were worried that our shareholder base was getting increasingly frustrated and we needed to solve for it."

The best of times

Geoff Wilson of Wilson Asset Management (WAM) is the King of LICs. His empire of eight LICs across global equities, domestic equities and alternatives is capitalised at over $3 billion. The retail subscriber base for the WAM weekly newsletter is over 70,000. Wilson loves the discounts, such as saying: *"As an investor, getting the opportunity to buy $1 of assets at 80¢ is exciting."*

Here's what Wilson said at the Morningstar conference:

"To me the discounts are great, that's nearly the Holy Grail. And the great thing about your chart is it showed how there are big variants, big discounts but also big premiums. You look at the leaders, AFIC and Argo. Look at AFIC at the moment. It's trading at 18% plus premium. So there are some great opportunities.

I think what a lot of people forget is for Listed Investment Companies, there's four things you've got to do.

One is you've got to perform for the investors.

Second, you need a growing stream of fully franked dividends because a lot of the marginal buyers are the self-managed super funds, trying to get this consistent dividend flow.

The third thing is what every listed company has to do and it's treat shareholders with respect.

And the fourth thing is … and this is what a lot of the newer investment companies don't necessarily get initially … is you've got to have a really detailed shareholder engagement communication and marketing strategy. And that is costly.

So a lot of the rationalisation that has occurred in the industry recently is where unfortunately, the manager just hasn't got that last bit right."

Wilson again promoted the merit of the discounts when Malseed asked about developments in 2022 and if the discounts had 'quietened down'. Wilson said:

"Look, there's some great value. You look at the two VGI LICs, now they're trading at 18% and 13% discounts, and since the Regal announcement, they've narrowed. And the Magellan LIC, we were buying it a little while ago at an 18% discount and I think it's only about a 13% discount at the moment. So you're getting a high quality manager cheaply.

On Chris's point, I take my hat off to the Pinnacle guys in terms of how they operated with Antipodes. If I was in that position, I probably would have left it in the structure. We had the same situation with WAM Research, traded at a big discount that actually took us seven years to get to NTA. The tough thing is when it takes that long you usually tighten up your shareholder base and that's where we've got the problem on the other side, we're at a 40% premium which is as ridiculous as the 30% discount that it used to be at.

But it does give you a great opportunity. There will always be Listed Investment Companies trading at premiums and there will always be Listed Investment Companies trading at discounts, and the logic of WAM Strategic Value was to take advantage of buying those discounts."

New funding rolls on

As there are few new IPOs of LICs, does that mean the sector is effectively dead, except for market variations on existing LICs? No, far from it. As the table below shows, existing LICs and Listed Investment Trusts (LITs) continue to raise money from existing and in some cases, new investors. There may be a question whether some of these transactions disadvantage investors who do not participate by issuing shares at a discount to NTA, but the same can be said of share placements to favoured investors by any company. This ability to build the investor base is one reason many managers will persist with LICs, and over $700 million raised in a quarter is impressive.

Share purchase plans, placements and entitlements, December quarter 2021

ASX Code	Company Name	Method	Shares Issued	Issue Price	Amount Raised
ACQ	Acorn Capital Investment Fund	Entitlement Offer	16,912,806	$1.60	$27,060,490
ALI	Argo Global Listed Infrastructure	Share Purchase Plan	13,583,886	$2.28	$30,971,260
CAM	Clime Capital	Convertible Securities	282,863	$0.96	$271,548
MOT	Metrics Income Opportunities Trust	Share Purchase Plan	11,253,378	$2.03	$22,844,357
MXT	Metrics Master Income Trust	Share Purchase Plan	48,593,750	$2.00	$97,187,500
PL8	Plato Income Maximiser	Share Purchase Plan	61,838,499	$1.10	$68,022,349
PL8	Plato Income Maximiser	Placement	64,264,974	$1.11	$71,334,121
QRI	Qualitas Real Estate Income Fund	Shortfall Placement	84,654,756	$1.60	$135,447,610
QRI	Qualitas Real Estate Income Fund	Entitlement Offer	22,612,423	$1.60	$36,179,877
RF1	Regal Investment Fund	Entitlement Offer	25,148,601	$3.79	$95,313,198
RF1	Regal Investment Fund	Placement	30,874,332	$3.79	$117,013,718
SNC	Sandon Capital Investments	Shortfall Placement	14,125,565	$1.01	$14,266,821
SNC	Sandon Capital Investments	Entitlement Offer	8,050,281	$1.01	$8,130,784
TCF	360 Capital Enhanced Income Fund	Entitlement Offer	279,845	$5.94	$1,662,279
WHF	Whitefield	Convertible Securities	311,461	$5.58	$1,738,550
					$727,444,462

SOURCE: COMPANY DATA, IRESS, BELL POTTER.

Coming back to Pinnacle, the above table shows why they support the LIC structure for the right asset or fund manager. Plato and Metrics are Pinnacle boutiques, and they have both written articles (here and here) in Firstlinks explaining why the LIC structure suits them. Here's Malseed and Meyer again:

MM*: In terms of Pinnacle's outlook for LICs and other listed structures, what's the pipeline for new launches and in what sort of areas?*

CM*: Pinnacle is very committed to the LIC sector. We think the future is pretty bright. It wouldn't appear obvious right now, because there hasn't been that much (IPO) capital raised in the last couple of years. But a couple of things. The discounts have tightened a lot, so that problem is not solved but it's way better than it was. Capital is starting to flow again. With existing LICs, the strong will get stronger. Geoff's stable is a good example of that. We've got Metrics, a repeat capital raiser because it's in high demand. But my personal view is that future IPOs will be more in private assets. Investors want it and need it. When you look at a typical retail investor's portfolio, full of stocks and bonds, not much in infrastructure, real property, private equity, those sort of asset classes.*

The LIC structure is perfect for those asset classes because it's closed-end. You've got an illiquid asset class in private assets. You can't have daily redemptions. You can't put it in an ETF. You can't put it in an unlisted managed fund. A LIC is perfect for it. And the LIC structure provides the investor with liquidity. So you get this Holy Grail of the reason why the structure makes sense. We've seen this in the UK where about 40% of LIC assets are in those private asset classes, real estate, private equity, credit. Here, it's about 10% in Australia and I think that pendulum is going to shift."

A bad investor experience cannot be a Holy Grail

So that's two Holy Grails. Wilson thinks it's the discount, Meyer thinks it's the investor liquidity in an illiquid asset class.

I'm with Meyer. Many investors are tired of the inability to exit from their LICs or LITs at the value of the assets. When liquidity was most wanted during the March 2020 COVID-19 sell off, discounts widened significantly. With buying interest in a closed-end fund relying on finding bids in the market, prices collapsed more than the fall in the market.

My own experiences over the years is that LIC discounts can move out and remain persistently wide for years. If something happens at the manager, such as a change in personnel or an unwelcome portfolio change, some LICs are so poorly supported that investors are forced to hang on or liquidate at a 20%+ discount. More of the small LICs should be consolidated into a structure offering better liquidity. To Wilson's credit, he has been vacuuming up LICs and merging them into his larger funds.

What Wilson should acknowledge is that it can hardly be a Holy Grail when an investor loses 20% versus the underlying asset performance as a reward for supporting the manager in an IPO. That investor's bad experience means they will not come back for more LICs and it's not an endorsement of a structure when the end-investor circumstance is poor, as Meyer experienced with Antipodes, Simon Shields with Monash and Ashok Jacob at Ellerston.

The final line of Dickens' *A Tale of Two Cities* is said by a man before he is executed at the guillotine:

"It is a far, far better thing that I do, than I have ever done, it is a far, far better rest that I go to than I have ever known."

It would be a far, far better thing if discounted LICs with ineffective or insufficient marketing resources or poor investment underperformance would guillotine themselves and either convert to an unlisted fund or merge with a larger fund and put their investors out of their misery.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Firstlinks
a Morningstar company

House prices: are we heading for oversupply from 2022?

Chris Bedingfield

According to CoreLogic, Australian house prices increased +22.1% in 2021, led by Australia's largest city of Sydney (+25.3%). There are a few culprits behind this stellar performance, including record low interest rates, healthy household balance sheets and a desire to re-invest in the home as some workers contemplate an extended 'work from home' environment.

The uplift in residential prices is not a local event. The value of homes has soared across the world, including New Zealand (+27.6%), the United States (+19.1% to October), the UK (+10.0%) and even places like Turkey (+40.0% to October). And for those who believe interest rates drive property prices, the average key interest rate in Turkey during 2021 was 18%, up from 11% in 2020.

As we head into 2022, there is an expectation that interest rates will rise around the world in response to recent inflation data. That may be true, but we do not believe this will be enough in itself to stop the gains. In fact, rising rates may add to further gains, as per Turkey.

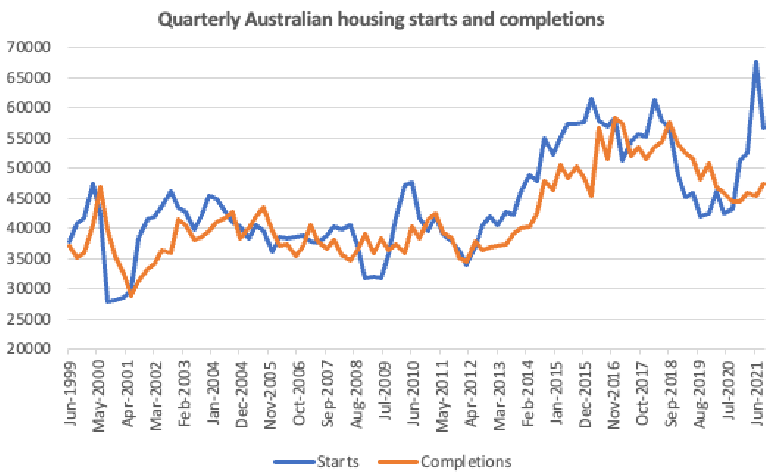
The biggest risk for investing in residential property is, as always, excess supply.

The housing cycle

While there are many theories as to what drives house prices, ranging from interest rates and lenient tax rules to immigration, residential property prices ultimately mean-revert around replacement cost. As prices increase above the 'cost to build' there is almost always a supply response, as developers try to cash in on the margin. Ultimately, increasing supply dampens prices back to a level where supply is restricted and the cycle starts all over again.

So, is the surge in residential property prices causing a supply response? In Australia, the answer is an emphatic **yes**.

The surge in new housing starts since COVID is similar, albeit sharper, to the 2015-2018 cycle which ultimately saw prices correct in 2019. We have yet to see any heat come out of the Australian market. Completions have yet to increase as they lag starts by around a year. Inevitably, completions will surge this year to match the starts, which may be somewhat ominous for the Aussie housing market.



Source: ABS, Quay Global Investors

Quantifying the oversupply (if any)

A surge in supply is not always a bad sign. The critical question is whether there is more total housing stock *relative* to overall housing occupier demand. To answer this, we will need to quantify the magnitude of the potential oversupply, if there is any. This is always a difficult task, as it not only relies on supply data but also household formation data, which can be notoriously fickle.

We can get a general sense of any imbalances using historical trend data. For example, Australian household starts ran at a consistent 40,000 per quarter between 2000-12, which appears to reflect a balanced housing market (no acceleration or deceleration in supply). Post 2012, supply accelerated as immigration increased. Adjusting for the increase in annual immigration from 1.4% per annum (2000-2011) to 1.7% per annum (2011-2019), steady-state supply can be estimated at ~50,000 per quarter, being household starts of 40,000 increased pro-rata with a higher immigration rate.

Using this assumption and based on housing starts data, we can estimate the cumulative supply shortfall since 2010.

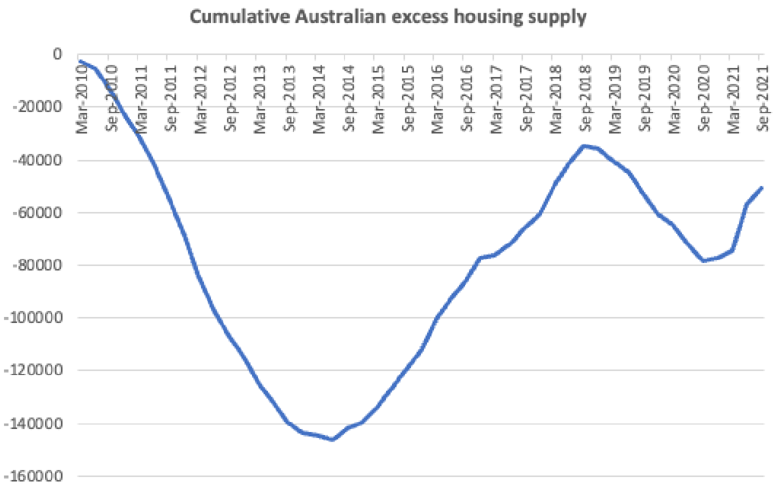
Generally, the Australian housing market has defied most gloomy predictions. Indeed, there was almost a small cottage industry dedicated to predicting the imminent collapse of Australian house prices in the post-financial crisis world.

However, the chart above demonstrates that there has never been a situation where there has been excess supply of housing in Australia. Accelerating housing starts (as prices rise above replacement cost) were quickly absorbed by new households.

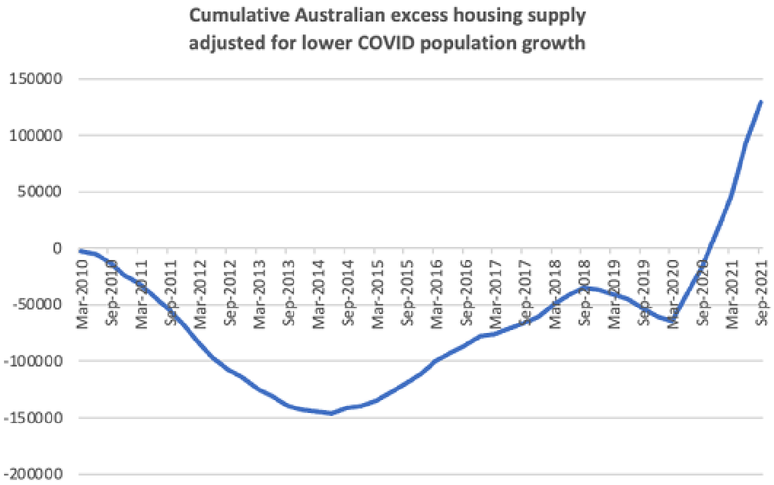
For Australia, population growth has generally provided Aussie housing the ultimate 'get out of jail free card' just as the market begins to cool. We made a similar observation in our June 2019 article [What now for residential property?](), where we reversed our earlier bearish 2017 call.

However, with COVID, population growth effectively halted right at the time supply was accelerating. For example, if we were to reduce our household growth assumption to 20,000 per quarter (60% reduction), the residential market would quickly become oversupplied (once current projects complete later in 2022).

We don't believe it is time to call for a market correction just yet, but based on the above chart it seems unlikely recent national residential price growth will be repeated in 2022.



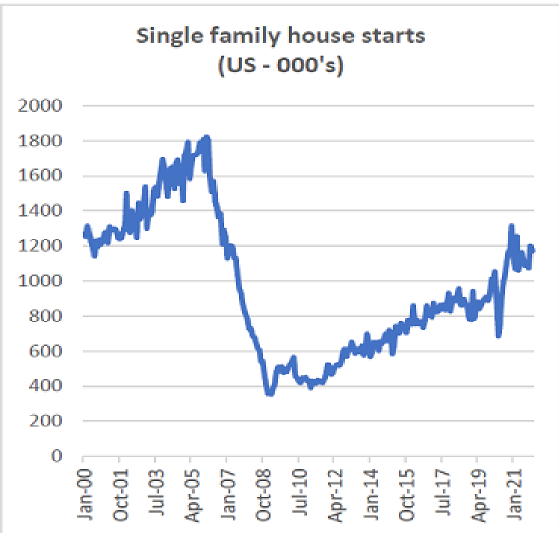
Source: ABS, Quay Global Investors

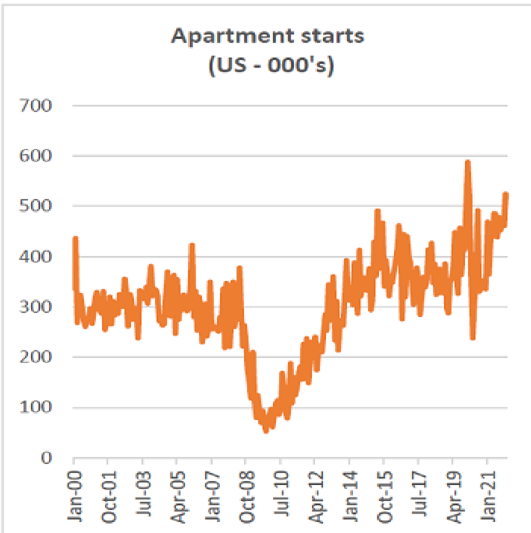


Source: ABS, Quay Global Investors

What about the US?

Recent strong increases in US residential property prices have also come with a surge in new supply, in both houses and apartments.





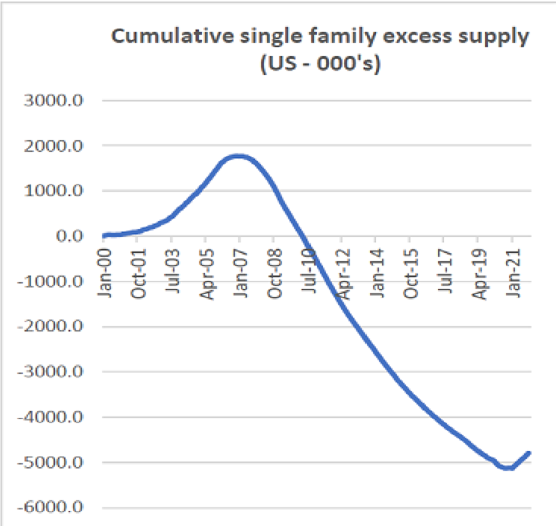
Source: St Louis Fred, Quay Global Investors

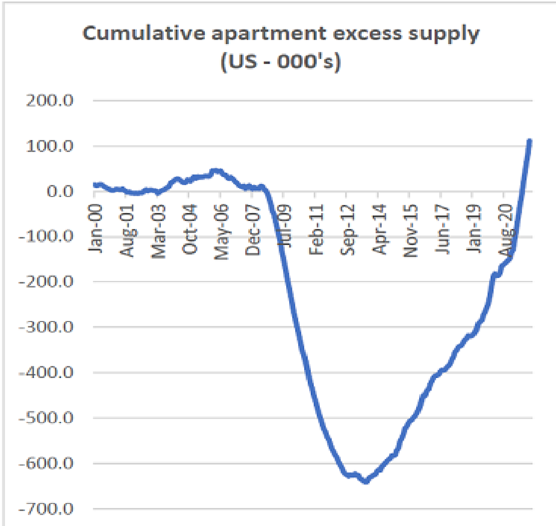
Does the US face the same supply headwinds as Australia?

To answer, we have applied the same methodology as the Australian analysis above. Specifically:

- We have assumed a normal supply run rate of 2 million single family homes per annum (consistent with pre-GFC bubble average) and 3 million apartments per annum (consistent with pre-GFC bubble average), and
- We have also assumed this required supply falls by 60% from mid-2020 to account for the collapse in immigration.

The following charts reflect the result for each sector.





Source: St Louis Fred, Quay Global Investors

For single family, there was a significant increase in excess supply leading to the GFC, which offers no surprise since prices boomed and were well above replacement cost. However, the single-family sector was crushed post crisis in terms of price (and ultimately resources), resulting in a significant deficiency in supply, even after allowing for the pandemic-induced collapse in immigration.

Conversely, US apartments never felt the effects of excess supply in the lead-up to the GFC. Also, unlike single family homes, apartment supply recovered more quickly in response to the demographic demands of millennials leaving home in the first half of the 2010s. However, with the decline in immigration there appears to be a growing risk that apartments are moving into excess supply for the first time in decades.

Risks of oversupply

The boom in global residential prices is another side-effect of the pandemic that seems to have caught many by surprise (us included). With any residential boom come concerns of a 'new bubble' and imminent crash. This type of reaction is understandable, given the deep scars left from the financial crisis a decade ago.

But by digging into the data, it is clear not all markets face the same risk. The cumulative undersupply in US single family housing is still significant and may take many years to rectify, especially now the sector has a demographic tailwind with the millennials, the largest US demographic cohort, seeking a more stable accommodation to marry and raise a family in a home.

The outlook for US apartments and Australian residential is less sanguine. For the first time in decades, there is a real risk these markets are facing a headwind of persistent oversupply, exacerbated by pandemic-induced immigration declines.

A word of warning: this analysis is not meant to be all-encompassing and each market has its own subtleties and nuances. We are not necessarily predicting a 'crash', or even a correction in these markets. The investment market is littered with the dead bodies of housing perma-bears.

But the data suggests that one of the best risk/return profiles is in US single family housing, which is where our fund maintains a significant investment position.

Chris Bedingfield is Principal and Portfolio Manager at [Quay Global Investors](). This article contains general information only, and does not constitute financial, tax or legal advice. It has been prepared without taking account of your objectives, financial situation or needs.

Howard Marks on selling versus staying invested

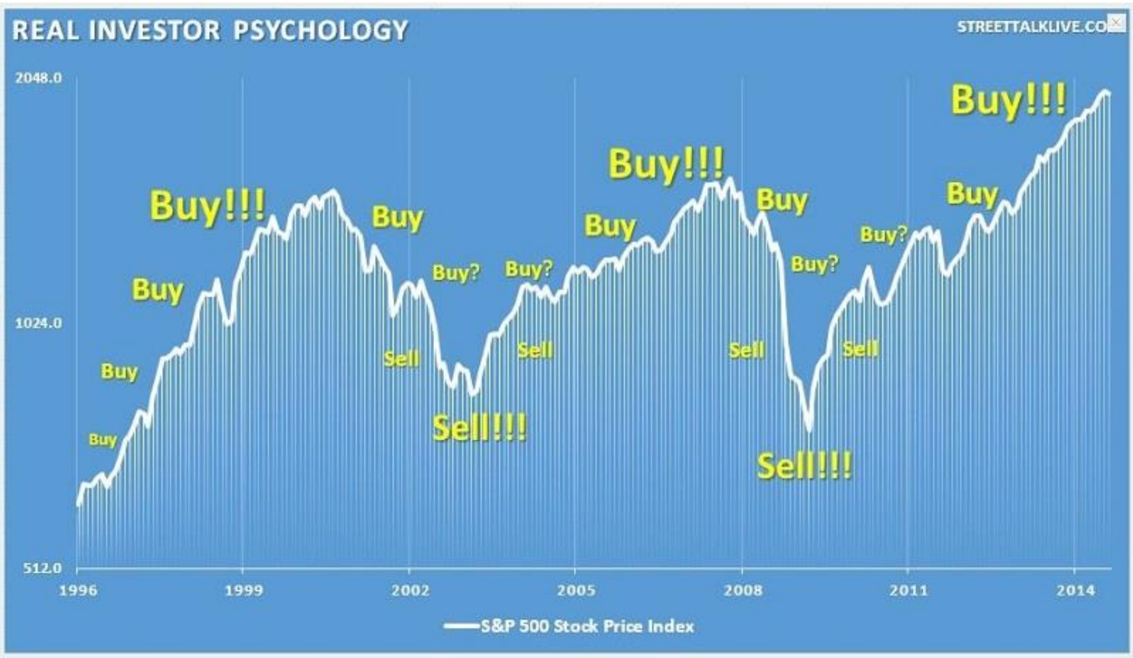
Graham Hand

After 40 years of writing memos to his clients, Howard Marks of Oaktree Capital realised he had never written about selling. It's surprising given the impact of the sales decision on investment results, and in particular, missing out on subsequent market gains.

Numerous studies show the average fund investor performs worse than the average fund, and it's mainly due to the entry and exit decision. Here is a typical chart which I often use during investor presentation, and while it might be exaggerated, there's much truth to it. Inflows to funds tend to be at their maximum after a strong run and a market peak when investors are confident. Fewer people have the fortitude to buy after a sell-off, and worse, they sell because they fear further falls. This 'buy high, sell low' attempt at timing is rarely successful.

Marks cites Charlie Munger of Berkshire Hathaway, who notes that selling based on market timing gives an investor two ways to be wrong: the decline may or may not occur, and if it does, when is the time to reinvest?

Marks notes that the people who sell before a market fall and "*too often may revel in their brilliance*" but then they fail to reinvest at the market lows, so what did they achieve?



Who can hang on faced with big gains or losses?

Marks uses the classic example of buying Amazon to show how tough it can be hanging around for the long-term results. Amazon floated in 1998 for US$5, and it's now US$3,304 (up 660X). But it hit US$85 is 1999, or 17X in less than two years, so who would not have been tempted to sell then? By 2001, it was down 93% to $6, so who would have panicked? And by 2015, it was back to $600, or 100X the price of 2001. Selling at a wonderful $600 would have missed 82% of the subsequent rise. Says Marks:

"When you find an investment with the potential to compound over a long period, one of the hardest things is to be patient and maintain your position as long as doing so is warranted based on the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell."

Investing is a relative selection

Many investors sell when a share price rises because they do not want to lose the profit. Nobody enjoys seeing a big gain disappear. But likewise, many investors worry about allowing losses to compound. It's bad enough when a stock loses 10%, but letting it go further to 20% or 30% seems neglectful. So markets up, markets down, investors tend to overtrade.

Marks is keen on an idea taught to him when he first started in the market by a mentor, Stanford University Professor Sidney Cottle, that all investing is a 'relative selection'. Marks says:

"Selling an asset is a decision that must not be considered in isolation. Cottle's concept of 'relative selection' highlights the fact that every sale results in proceeds. What will you do with them? Do you have something in mind that you think might produce a superior return? What might you miss by switching to the new investment?"

And so despite the risk of market falls, Marks says the most important thing is 'simply being invested'. Buying and selling based on market timing is not likely to work and misses the potential for upside.

Backing his view, he cites data showing long-term returns from markets and the risk of missing out on a few days. In particular, anyone starting out investing as a young adult will do well by the time they retire. For example:

"JP Morgan Asset Management's 2019 Retirement Guide showing that in the 20-year period between 1999 and 2018, the annual return on the S&P 500 was 5.6%, but your return would only have been 2.0% if you had sat out the 10 best days (or roughly 0.4% of the trading days), and you wouldn't have made any money at all if you had missed the 20 best days. In the past, returns have often been similarly concentrated in a small number of days. Nevertheless, overactive investors continue to jump in and out of the market, incurring transactions costs and capital gains taxes and running the risk of missing those 'sharp bursts'."

One of the basic tenets of investing

Marks says that when the five founders of Oaktree established an investment philosophy in 1995, one of the six tenets focussed on market timing and inability to predict markets:

"We keep portfolios fully invested whenever attractively priced assets can be bought. Concern about the market climate may cause us to tilt toward more defensive investments, increase selectivity or act more deliberately, but we never move to raise cash. Clients hire us to invest in specific market niches, and we must never fail to do our job. Holding investments that decline in price is unpleasant, but missing out on returns because we failed to buy what we were hired to buy is inexcusable."

I would qualify this by acknowledging that the portfolio should participate in the upside but not carry so much risk that the investor cannot sleep at night worrying about losses. Too much focus on preparing for losses is a mistake but there is no one-size-fits-all in investing. Many retirees simply cannot tolerate losing the money they have to live on when there is little or no capacity to return to work.

Marks' bottom line

Howard Marks sums up his latest memo saying there is no ideal portfolio and no complete way to assess risk. Therefore:

- We should base our investment decisions on our estimates of each asset's potential
- We shouldn't sell just because the price has risen and the position has swelled
- There can be legitimate reasons to limit the size of the positions we hold
- There's no way to scientifically calculate what those limits should be.

"In other words, the decision to trim positions or to sell out entirely comes down to judgment, like everything else that matters in investing."

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Is there any point in holding cash?

Geoff Warren

With yields on cash-like assets barely above zero, it begs the question of whether cash has any role in a portfolio apart from for liquidity purposes. Shouldn't cash be held at minimal levels given the lack of any meaningful return? Not so quick!

Cash offers a unique feature – capital protection. If you invest $1 in cash, you can expect to get your $1 back plus (a little) interest. Other assets do not offer this feature because their prices fluctuate. This positions cash as the asset that might help defend the portfolio if *all* other assets fall in price for some reason.

Here is a framework for thinking about cash and a plausible scenario under which a ubiquitous bear market in all assets would see cash provide a safe haven.

More complex than just getting your dollar back

Of course, the nominal value of capital is not all that matters. 'Real' (inflation-adjusted) purchasing power also needs to be considered. Real purchasing power will be eroded if cash rates run at less than the inflation rate but will be protected if cash rates match or exceed inflation.

Real cash rates are currently negative, with cash-like assets that yield much over 0.25% not to be found without taking some capital (i.e. credit) risk. Meanwhile, the latest CPI readings are running at 3.5% in Australia and 7.5% in the US over a year ago.

An important point is that cash rates continually reset. This means that the future path of rates (and inflation) are more important than where both stand today. If cash rates rise in response to inflation so that real rates remain positive over time, then cash will protect the real value of capital and provide an effective inflation hedge. If cash rates do not keep pace with inflation, then real capital will be eroded, although this tends occur as 'capital death by a thousand cuts' rather than large one-off losses. How central banks conduct monetary policy is pivotal.

Breaking down the drivers of asset prices

My framework is one where asset prices are determined as the present value of future expected cash flows by applying a discount rate that reflects the return required by the market. Under this framework, asset prices can fall for two reasons.

First is a decrease in expected cash flows. A stock suffering a sell-off after the market revises down its earnings is a classic example.

Second is an increase in the discount rate. The latter amounts to the asset repricing down to offer a higher return going forward.

Cash is unique in that it carries no meaningful cash flow or discount rate risk (assuming no default risk). It is a promise to give back your invested capital plus any interest. As a consequence, cash will be most valuable in circumstances where broad-based reductions in cash flows or increases in discount rates occur that hit all other assets. Meanwhile, cash carries reinvestment risk because its rate of return continually resets.

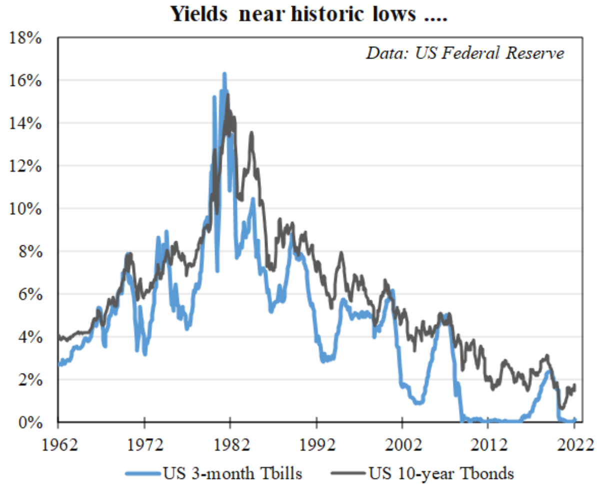
Broad-based decreases in cash flows across assets could occur in, say, a global recession. However, under such circumstances there are usually some assets that provide reliable cash flows that may help protect the portfolio.

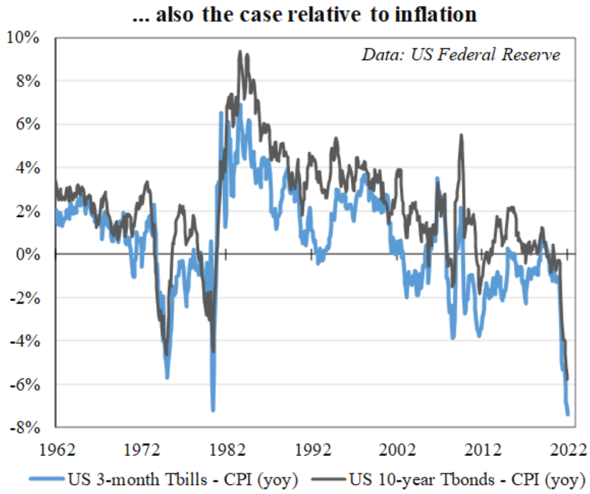
Government bonds have traditionally played this diversifying role, often more effectively than cash as discount rates also tend to fall during recessions. At least they have over the last 30 years or so.

Where cash can really come into its own is during an across-the-board rise in discount rates that hits the prices of all assets. This is where the danger seems to lie today.

A scenario where all markets reprice

Yields near record lows (see charts) and many assets trading on high multiples are signs that discount rates are currently low. The risk is that this may not be sustainable. Higher inflation and tightening by central banks mean that discount rates could be going up, possibly considerably. This would be tantamount to markets going from being broadly priced for low returns repricing downwards so that they offer higher returns.





It is possible to imagine a scenario where central banks take cash rates to 3%-5%, government bond yields return to above 3%, multiples on equity-like assets shift to lower levels, property cap rates move to higher levels, and the housing market needs to adjust to mortgage rates back at 5%-6%.

You get the picture. Nearly everything reprices down as discount rates rise. Equities, bonds, property, etc. all get hit. Meanwhile, cash holds its value.

This may not matter so much if cash flows were increasing at the same time. Here consideration needs to be given to the influence of inflation, and central banks that seem to have placed themselves behind the curve. Monetary tightening to rein in inflation involves restraining growth – that is the point, in part. But there is a chance that the result is more than a slowing in growth. This could occur either because inflation proves so intransient that aggressive tightening is required, or central banks miscalculate.

Of course, a combination of rising discount rates without an offset from rising cash flows is just one possible scenario. But it seems a scenario that is not too far-fetched given current circumstances. Holding some cash can help protect the portfolio if such a scenario eventuates and diversification fails.

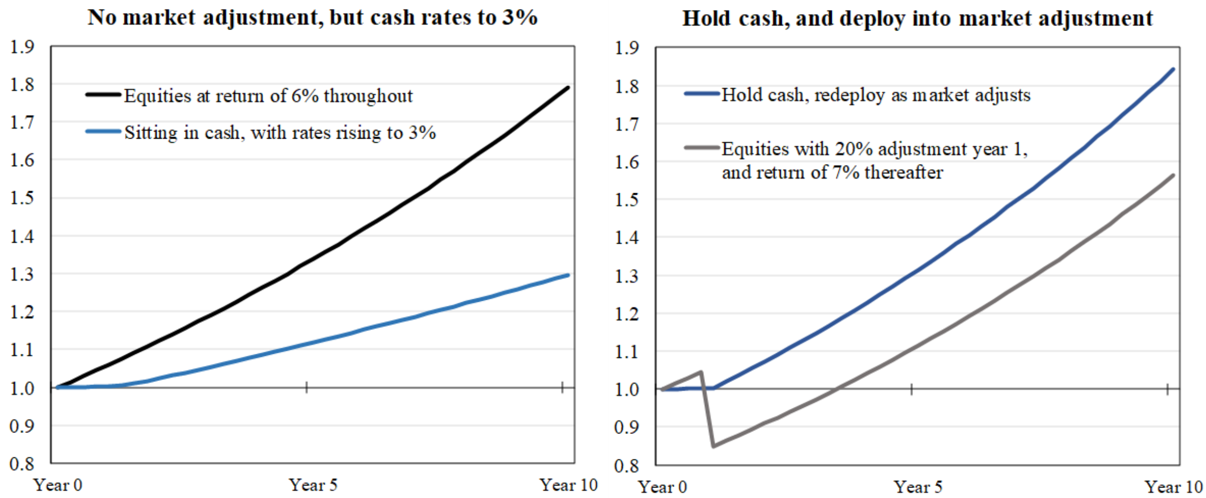
Two other things to consider

What happens to cash rates and inflation will determine the degree of capital protection provided. Will cash rates be returned to above inflation as central banks tighten, so that real capital is protected? Or will cash rates be maintained below inflation so that cash continues to erode real purchasing power thus diluting the benefit of the hedge?

It is a moot point how much tightening is required to rein in inflation, and how far central banks are willing to go once the impacts on the markets and economies begin to appear. In any event, focus should be on the future trajectory of cash rates relative to inflation, rather than where rates and inflation stand today.

Another issue is grappling with the market dynamics. The charts below illustrate what could happen if the market continues on while you sit in cash, versus the scenario where cash is redeployed back into a market adjustment at a higher rate of return. But market timing is far from easy. If you shift to cash too early, and the market continues onwards only to correct from higher levels, there might be no net benefit.

Further, redeploying excess cash back into the markets once the adjustment occurs is tricky to execute. The benefit of the hedge would be much diluted, or even nullified, if cash is redeployed either too early and markets continue to fall, or too late so you miss the recovery. For some investors, staying the course but bracing for a possible hit might be a sensible approach.



In summary, cash is a defensive asset with unique attributes

My key message is that cash should be seen as a defensive asset with unique attributes that are valuable in certain situations, specifically when discount rates rise and prices fall across all assets. It at least protects the (nominal) value of capital and could also protect the real value of capital *if* central banks manage towards positive real rates in due course (no guarantees here).

Cash is better considered from this perspective and not treated as trash simply because cash rates are currently extremely low.

Geoff Warren is an Associate Professor at the Australian National University. He has also had an investment career spanning asset consulting, portfolio management, investment strategy and equity research; and currently sits on a number of investment-related advisory boards.

Stocks near their 52-week lows: is it time to reconsider?

Gemma Dale

The 2021 year was exceptional for many investors. The ASX200 gained 12%, excluding dividends, and the S&P500 rose over 25%, including an almost unprecedented 70 all-time-highs. But not all stocks soared, and some that did have come down to earth. Many are at or near their 52-week lows, having stayed flat or even fallen dramatically over the last 12 months.

Buying when stocks are down

Many long-term investors will be familiar with the Dogs of the Dow strategy, which involves buying the poorest performers of the previous year in the Dow Jones Index. This strategy is far from foolproof, but many nabtrade investors are keen to buy high quality stocks at a discount.

Here are some of the most popular stocks among our investors that are currently trading at or near their lowest price over 12 months, by sector.

Many stocks in the healthcare sector suffered during Covid19, as companies were unable to treat patients or otherwise access their key markets. Two of Australia's most successful healthcare companies, both leaders in their field, are currently trading close to their 52-week lows, with CSL (ASX:CSL) trading a little over $250 at the time of writing, well off its 12-month high of nearly $320, and even further from its pre Covid high of $350.

CSL has been frustrated in its efforts to collect blood plasma in the US and Europe due to Covid19 distancing restrictions, and has undertaken the high value acquisition of Vifor Pharma which was both debt and equity financed, putting the share price under pressure. Broadly, however, CSL's long term fundamentals do not appear to have changed.

Cochlear Ltd (ASX:COH) shares are trading below $195, which is above its 52-week low of $178 but well off 52-week high of $257. Both CSL and Cochlear have typically traded on high multiples due to their consistently high growth rates and relative strength in their target markets.

In financials, three of the big four banks have rebounded strongly from their Covid lows, however Westpac (ASX:WBC) has struggled to win market share and control costs, with its annual results in November disappointing shareholders and sparking a 10% sell off. The share price hasn't really recovered, at around $22 it is a little off its lows of $20 but well off its 52-week high of around $27. Westpac remains the most bought of the big four banks on nabtrade.

Magellan Financial Group (ASX:MFG) has suffered a series of blows over the last 12 months, including the resignation of its CEO, the loss of its largest institutional mandate and now the leave of absence taken by its Chief Investment Officer and key man, Hamish Douglass. Magellan is down over 60% year-on-year, as shown in the chart below.

Magellan (MFG)

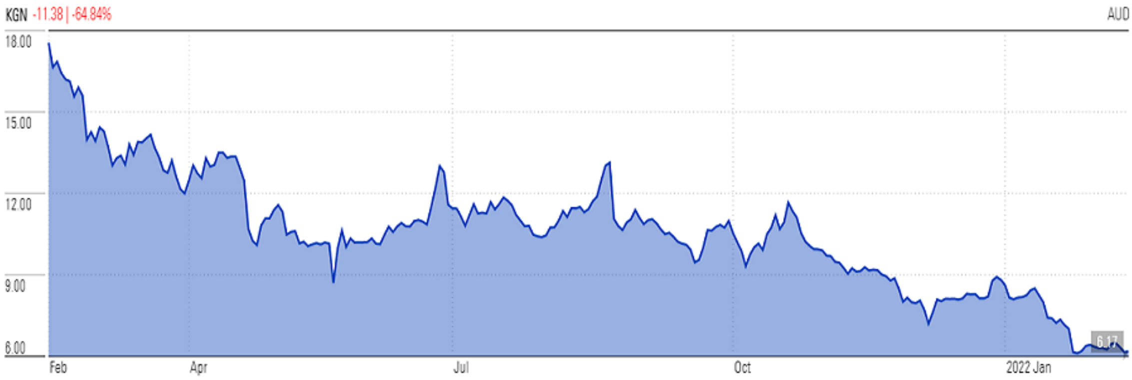
Source: Morningstar, as at 16 February 2022

Former blue-chip AMP (ASX:AMP) has bounced nearly 10% from its low of 85 cents but is still down nearly 40% over 12 months and has lost more than 90% of its value since the GFC.

Retailers, particularly online retailers, were one of the biggest winners from Covid19 as consumers were forced to change their spending habits. Harvey Norman (ASX:HVN) was also the beneficiary of a significant boost from JobKeeper payments, but some view the reopening as a negative for Harvey Norman, as consumers are more likely to spend on travel and experiences rather than goods. At the time of writing, HVN shares were off their 52-week lows but still 20% off their recent highs and down over 12 months, significantly underperforming the ASX.

Well-known online retailer Kogan (ASX:KGN) has had a wild ride. It is down again in 2022 and has lost over 60% in 12 months. Rising inventory and costs have worried shareholders and analysts.

Kogan (KGN)



Source: Morningstar, as at 16 February 2022

Tech comes back to earth

The sector most at risk of rising interest rates is technolgy, as the valuations for many high growth tech stocks are underpinned by an extremely low cost of capital and low discount rates for profits far into the future.

Australia's most popular tech sector remains buy now, pay later (BNPL), which has seen extraordinary growth but valuation setbacks recently. The leader in the sector, Afterpay (formerly ASX:APT) has been bought by US payments giant Block (formerly Square, SQ.US). The combined entity now trades under the code ASX:SQ2 on the ASX. SQ2 has lost 17% of its value since listing, and Afterpay had lost nearly 50% of its peak value prior to the transition. Zip Co (ASX:Z1P), one of nabtrade's most popular stocks in recent years, has lost over 60% of its value over 12 months, and is now at close to its 2020 trade price. Competitors in the BNPL space OpenPay (ASX:OPY) and Sezzle (ASX:SZL) are down over 80% and 75% respectively and are at or near their lows.

Also in the tech sector, accounting software provider Xero (ASX:XRO) is currently trading around $110 after peaking at $156 in 2021. However, Xero is still up 500% over five years and trades at a significant premium to the market. Another of the WAAAX stocks, Appen (ASX:APX) suffered a hit with Meta's recent disappointing results, and while off its lows is still down nearly 60% over one year. ELMO Software (ASX:ELO), which provides payroll solutions, has fallen 40% over 12 months, and is now at 2018 prices.

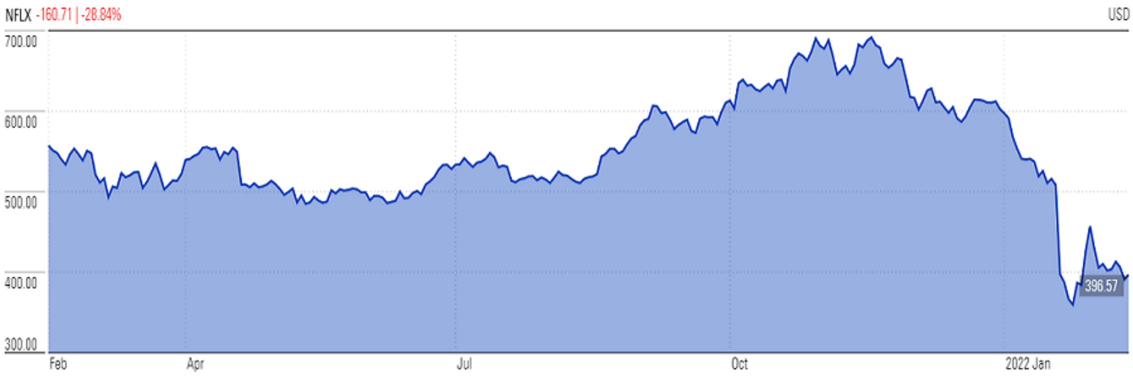
Data centre operator Next DC (ASX:NXT) is down 15% over a year, and while it has bounced from its sub $10 52-week low, is substantially off its 2021 high of over $14. Former rocket Nearmap (ASX:NEA), which traded above $4 in 2018, is now near its lows at $1.30, while online marketplace provider Redbubble (ASX:RBL) is off over 70% over 12 months.

Xero (XRO)

Source: Morningstar, as at 16 February 2022

For those willing to look beyond the ASX, the Nasdaq has a multitude of stocks trading substantially off their highs, with two of the FAANG stocks, Meta (formerly Facebook, FB.US) and Netflix (NFLX.US) down 11% and 25% respectively over 12 months. While Apple (APPL.US) and Microsoft (MSFT.US) are up over 25%, Paypal (PYPL.US) has halved, Zoom (ZM.US) has fallen more than 60% and the US-listed Block (SQ.US) is down 55% over a full year. Beyond the big players, there are many more tech names whose investors have suffered huge (paper) losses over 2021 and into the harsh January of 2022.

Netflix (NFLX)



Source: Morningstar, as at 16 February 2022

Worth a look?

So are these weak stocks a great buying opportunity, or a value trap for the unwary?

It depends upon the company. The large cap names with consistent earnings whose circumstances were affected by Covid are worth closer study. A company such as AMP, however, is hard to fathom and the oftpromised turnaround may never materialise. For the more speculative end of the market, the days of heady valuations that made more sense when cash rates were close to zero are probably over.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. Stock prices as at 7 February 2022. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

For more articles and papers from nabtrade, please click here.

SMSF returns competitive with big funds at $200,000

George Mihaylov, Peter Burgess

Introduction: In this report commissioned by the SMSF Association, researchers at the University of Adelaide used data provided by BGL Corporate Solutions and Class Limited from over 318,000 SMSFs between 1 July 2016 and 30 June 2019, to identify the minimum amount of capital required for an SMSF to achieve comparable investment returns with much larger funds.

When coupled with research by the actuarial firm Rice Warner in late 2020, which found SMSFs with balances of $200,000 or more were cost effective compared with industry and retail superannuation funds, it supports the competitiveness of SMSFs with balances of $200,000 or more compared with larger funds.

The research also found SMSFs generate greater variation in fund-level performance relative to APRA-regulated superannuation funds. SMSFs with more diversified asset allocations achieve higher returns.

***

Investment performance comparisons between SMSFs and APRA funds have historically been difficult to make. APRA relies on information from financial statements to generate a Rate of Return (ROR) for APRA regulated funds, whereas SMSFs are regulated by the Australian Taxation Office (ATO), which produces a Return on Assets (ROA) measure for SMSFs based on data collated from SMSF annual returns.

The research took anonymised financial statement data and calculated an annual ROR for each fund in the data sample. A median ROR for the SMSF sector was then derived from the individual fund RORs. To compare against SMSF median ROR, a similar approach was used for the APRA fund sector with a median APRA fund ROR derived from APRA's annual fund-level superannuation statistics back series.

Key findings

1. SMSF ROA consistently underestimates actual SMSF performance, with evidence suggesting this gap is widening over time.

The table below compares the differences between the ATO's published ROA returns for the SMSF sector and the ROR calculated for each individual SMSF in the data sample for the period 2017 to 2019.

	2017	**2018**	**2019**
Median ROR (via this research)	6.9%	6.0%	6.2%
Median SMSF ROA (via ATO)	5.0%	4.0%	4.3%

Source: Understanding SMSF performance, table 3.

The research found the ATO's median ROA calculation underestimates the SMSF median ROR on average by more than 1.9% over the 3-year period from 2017 to 2019. This is over 50% larger than what was presented to the Productivity Commission for the period 2006 to 2016.

There are fundamental and irreconcilable differences between SMSF annual return data and SMSF financial statement data. While in recent times the ATO has made adjustments to align their ROA calculation measure more closely with ROR, ultimately it is not possible for the ATO to fully replicate APRA's ROR calculation.

While it may be appropriate to use the ATO's SMSF median ROA and average investment return figures to compare the performance of the SMSF sector with other years, these figures should not be used to compare the performance of the SMSF sector with other sectors

2. SMSFs with net assets of more than $200,000, that are not concentrated in cash and term deposits, outperformed APRA regulated funds in two out of three years between 2017 and 2019.

When comparing the headline performance of APRA funds with SMSFs, at the median APRA funds outperformed SMSFs in two out of three years between 2017 and 2019.

However, when small cash-heavy SMSFs are excluded, the opposite result is observed – SMSFs outperformed APRA funds in two out of three years between 2017 and 2019.

	2017	**2018**	**2019**
All SMSFs	6.9%	6.0%	6.2%
APRA funds	7.8%	7.6%	6.2%
SMSFs with more than $200,000 and with less than 80% cash or term deposits	8.0%	6.6%	6.5%

Note: All returns in the above table are median RORs. Source: Understanding SMSF performance, table 6.

Of particular interest in this research study is the investment performance of SMSFs which actively invest. Excluding SMSFs which, either by default or choice, abstain from making investment decisions, provides a more useful indicator of performance.

Similarly, SMSFs with balances below $200,000 are more likely to lack the critical mass required to keep pace with larger funds (see research result 5).

Excluding SMSFs which meet either of these conditions (i.e. SMSFs with balances below $200,000 or with more than 80% of the fund balance invested in cash and term deposits) provides a more meaningful comparison of performance relative to APRA funds.

The research found SMSFs with significant cash holdings were associated with significant performance impairment for the three years between 2017 and 2019. The research also found a strong positive relationship between fund size and fund performance for balances up to $200,000. These results indicate the overall performance of the SMSF sector could be improved by identifying and assisting investors with small, cash heavy SMSFs.

3. SMSFs generate greater variation in fund-level performance relative to APRA funds

SMSFs have a higher propensity to outperform and a higher propensity to underperform relative to APRA funds.

While this is a feature of the broader range of investment options available to SMSF investors, it is also a feature of the significant difference in population sizes between the two cohorts.

The greater variation in fund-level performance, and a higher propensity to outperform relative to APRA funds, presents opportunities for advisers to add value, and deliver higher rates of return for suitable superannuation investors.

It also presents opportunities for advisers to assist SMSF investors who have a higher propensity to underperform.

4. In aggregate, SMSFs with more diversified asset allocations achieve higher returns

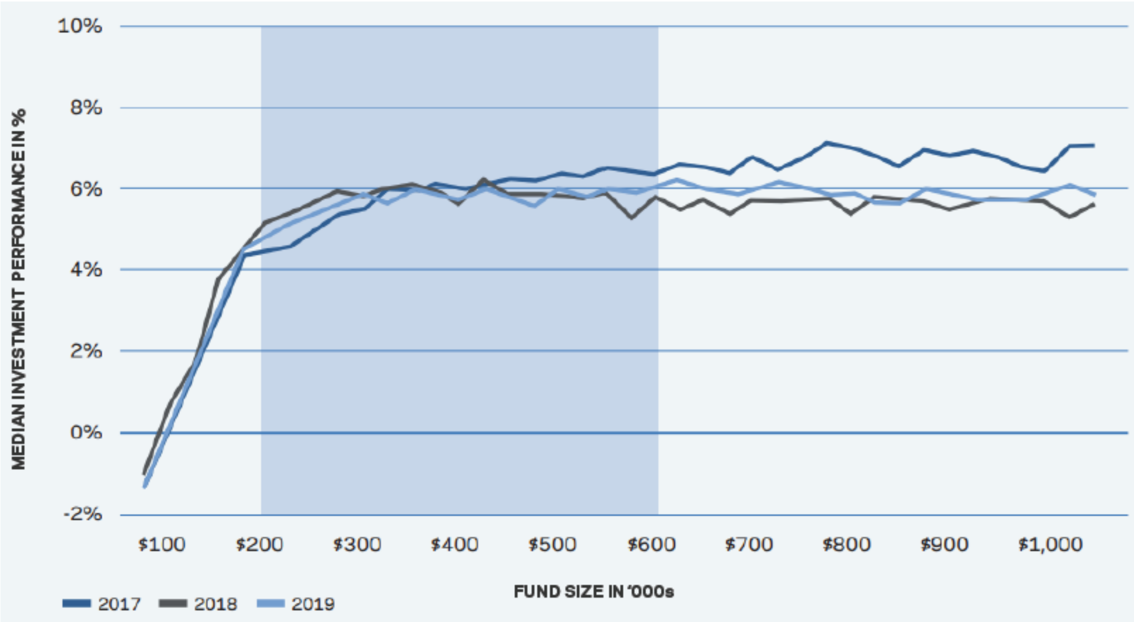
The performance benefits of adding a second, third or fourth asset class are strong and consistent across the 2017–19 period. Each incremental increase in asset classes (up to 4) is associated with an improvement in median ROR of between 1% to 3%. Diversification beyond 4 asset classes (up to 7) also improves aggregate SMSF performance, but at reduced marginal rates.

The results are consistent with standard finance theory. Higher levels of diversification are correlated with improved levels of investment performance.

The research results provide tangible evidence of the benefits of diversification. The research results underline the benefits of a properly formulated investment strategy and supports the regulatory focus on SMSFs with inadequate levels of investment diversification.

5. SMSFs achieve critical mass at balances of $200,000 or more

The performance of a typical SMSF improves as the balance of the fund approaches $200,000. Once this threshold is reached, the performance of the fund is comparable with SMSFs with much larger balances as illustrated by the flat line in the shaded zone in the figure below.



Source: Understanding SMSF performance, figure D2.

The research supports the regulatory focus on fund size, but it also suggests that current guidelines around minimum SMSF balances are poorly calibrated. The research data revealed no material differences in performance patterns for SMSFs between $200,000 and $500,000, so the notion that smaller SMSFs in this range deliver materially lower returns, on average, than larger SMSFs in this range, is not supported by the research results.

Fund size is important, but mainly for explaining the performance of SMSFs with balances up to $200,000. Beyond this threshold, fund size does little to explain fund performance, at least for the period 2017-2019.

This result complements research released by Rice Warner in 2020 on the cost of operating an SMSF which found SMSFs with balances of $200,000 or more, are cost competitive with both Industry and Retail funds.

In relation to fund size, prospective and existing SMSF investors (and their advisers), should have confidence in the performance prospects if they have $200,000 or more in net assets.

Peter Burgess is Deputy CEO and Director of Policy & Education at The SMSF Association. George Mihaylov is a Lecturer at The University of Adelaide's International Centre for Financial Services. The full research paper can be downloaded here. This article is general information only.

What real estate agents don't tell you (redux)

Graham Hand

Introduction. *This article was originally published in 2015, and is reproduced here after a friend told me he was looking at buying an apartment in a holiday resort. One of the attractions is the ability to stay in the apartment when it is not rented out for short-term holidays. He said there was no point leaving money in the bank earnings nothing and shares are too risky. This sounds like a scenario being considered by many readers looking for income in new places.*

I'm sure he thought I would smile pleasantly and he would drive off to buy his dream with a view. I sent him this article and he's definitely having second thoughts. I have not changed any of the numbers so please read it knowing it is seven years old. The arguments remain valid. These resorts are a crap shoot.

Coincidentally, I stayed on the Gold Coast last week, this time further south than usual in an apartment at Bilinga, near Coolangatta. From there, the thousands of towers of Surfers Paradise and Broadbeach loom large on the horizon, a mass of short-let apartments ranging from the luxury to the downright trashy. The experience of owners no doubt covers the full range from wonderful to woeful, but anyone buying into a resort for short-term let should know what they are going into ... mainly financing the holidays of other people.

***

Explore the rear entrance of an apartment hotel or resort that is more than five years old and take a look at the contents of the skips in the lane outside. They are often full of sofas, dining chairs, mattresses and televisions. Seven years earlier, when the proposal for a shiny new building was just a model in a display apartment for off-the-plan sales, hundreds of dreamers signed up to buy apartments. They also agreed to a furniture package for $40,000 to allow the building to operate as a hotel or resort. After years of people on holidays staying in the rooms, jumping on the sofas and leaning back on the chairs, the furniture needs replacing. Over the five years, that's another $8,000 a year of costs to write off for each owner. It's not such a dream now.

A few years later, the apartment will probably need a new bathroom and kitchen. How many years of income will that cost?

If you don't believe a sofa lasts only five years, you've probably never owned one of these short-let apartments. Hundreds of kids and honeymooners and party animals have enjoyed themselves on the furniture while on holiday. Have you ever watched coverage of schoolies week?

The most misleading number in investing

Real estate agents quoting gross yields on residential property are using the most misleading number in investing. The costs associated with residential property consume most of the income, leaving uninformed investors blind to the actual returns until the expenses start to come in. In an era where the professionalism of financial advisers is slammed daily in the media, many property agents get away with poor disclosure without comment.

Obviously, this is not a marginal asset class few people care about. Residential real estate in Australia is worth $5.8 trillion, and it dwarfs listed equities of $1.6 trillion and superannuation of $2 trillion. It accounts for over half of Australia's wealth (see CoreLogic Housing and Economic Market Update, April 2015).

Why are gross versus net yields so important for real estate?

Invest in a term deposit at 3% and you will earn 3%. There are no other costs involved. In equities, the effective yield earned can be better than the quoted dividend rate when imputation credits are added back. But residential property is the opposite. Net yields should be the main focus because expenses are high and unavoidable, even if the property is left empty.

A typical commentary on a real estate 'entertainment' programme goes like this:

"Is this a buy or a sell? It's a one-bedder only 10 kilometres from the centre of Sydney, close to buses, 65 square metres, asking $750,000, would rent for $650 a week."

"Well, the starting point is you don't want to be out of this market," replies the agent confidently. "This place will be worth $50,000 more in a year – that's $1,000 every week. And look, $650 a week is about $35,000 a year, that's a yield of 4.5%. Where can you get that today?"

Can you imagine what ASIC would do to a licensed adviser who spoke like that, or included it in an offer document? Prices do not always rise, and that yield is not available by buying that apartment.

CoreLogic quotes rental rates of 3.7% for 'combined capitals' across Australia, but this number is gross rental yields (for example, see page 7 of above-linked report). It's the number the industry loves to talk about. But even if we put aside stamp duty, legal costs, borrowing costs and vacancies, what about the regular costs of owning a property? These are the ongoing drains on income that are often overlooked. According to a Reserve Bank of Australia Research Paper, 'Is Housing Overvalued' (June 2014), the running costs of long term rental properties are 1.5% per annum, and transaction costs of 7.3% averaged over ten years are 0.7%, giving costs of 2.2% per annum.

That takes the net yield to 1.5% before allowing for repairs and maintenance. Reality is completely different than the real estate brochures and entertainment programmes convey.

How do management rights work?

When a large apartment building is constructed, the lots or units are purchased either by people who want to live in them (owner occupiers) or let them (investors). The 'management rights' to the building are sold by the developer, which gives the manager the right to charge a fee to look after the building and in some circumstances, run a letting scheme. The manager estimates how much income the building can generate when deciding how much to pay for the rights.

Of course, there are hundreds of thousands of different schemes in Australia, ranging from small premises run by mum and dad to professional managers (including listed companies) who may pay up to $15 million to manage a large, prestigious building by the beach with great views. The management rights might include running a restaurant, a reception centre, housekeeping, a real estate business as well as the letting and maintenance. Income includes payments from the body corporate, plus owners who enter a letting agreement pay a percentage of the letting charges, say 8% for long term letting and 12% for short term. The vast majority of apartment buyers in a hotel or resort sign up with the manager because there are efficiencies in one person managing the whole building. But what the buyer does not realise is that every change of a light bulb, every adjustment of the remote control, and every time the room is cleaned is a money-making opportunity to recover that $15 million.

Higher income, higher expenses

An apartment costing say $500,000 might rent permanently for $500 a week, but as part of a hotel, $250 night in high season. How can this not be a better deal? Consider the examples of well-established apartments in hotel or resort schemes targeted at short-term letting shown in Table 1.

Table 1: Extracts from tax returns for typical short-term letting apartments

Type	Estimated Value	Financial Year	Income	Expense	Net income
1 bedroom NSW	$500,000	2013/2014	$62,475	$46,881	$15,594
		2012/2013	$56,248	$40,083	$16,165
2 bedroom QLD	$500,000*	2009/2010	$20,944	$29,684	-$8,739
		2008/2009	$24,740	$31,388	-$6,648
		2007/2008	$26,631	$31,473	-$4,842
3 bedroom QLD	$350,000	2013/2014	$27,946	$28,018	-$72

*Bought in 2004 for $500,000, sold in 2011 for $505,000 (gross before costs).

The expenses from short-term letting are far more than permanent, especially costs such as cleaning and replacing equipment. Owning an apartment for short-term letting can be an annoying experience of monthly expenses to maintain the apartment to the standard required by the hotel or resort manager. More detail from the tax returns of these apartments is shown in Table 2.

It's hard to believe a small apartment can incur $47,000 in costs a year. People who put their apartments into these letting pools are probably prepared for some of the same costs as long-term rentals, such as strata fees and council rates, but who expects regular costs such as those shown in Table 3.

It's a monthly crap shoot. The owner pays $360 a year for the phone system, and could buy the television for a year of hiring fees. The dry cleaning can be $100 a month. The cost of cleaning a one-bedroom apartment after one night is an unbelievable $73. How long does it take to clean a small apartment in a building with 200 such apartments? If you think the management fee should cover the quick visits to the apartment and complaints by guests, read the fine print. There is no way of knowing how often a light bulb is replaced or a bed cover dry cleaned. Who dry cleans a shower curtain every month? That $1 light bulb costs $23 to replace. This is a big money earner for the manager. A guest might stay for one night and after expenses such as booking agent fees, advertising levy, housekeeping and repairs, little is left for the owner. It's not worth the wear and tear on the apartment.

Firstlinks
a Morningstar company

Table 2: Detailed income and expense returns

Income or Expense	3 bedroom QLD	2 bedroom QLD	1 bedroom NSW
Rents received	$27,946	$20,944	$62,475
Expenses			
Advertising for tenants	$922	$264	$3,124
Body corporate fees	$6,246	$7,309	$8,247
Cleaning	$3,693	$4,099	$15,568
Council rates	$1,458	$3,521	$936
Depreciation on plant	$1,422		$2,123
Insurance	$931		
Property agent fees	$3,689	$8,683	$8,205
Repairs and maintenance	$671	$4,793	
Special building write off	$1,772		
Water charges	$1,666		$694
Linen	$2,419		
Electricity	$1,121	$834	
Total expenses	**$28,018**	**$29,684**	**$46,881**
Net rent	**-$72**	**-$8,739**	**$15,594**

(Tax returns do not use the same categories in every case).

Table 3: Examples of specific expenses in short term letting

Typical Expenses	Amount
Cost of cleaning one-bedder after a one night stay	$73.32 per night
Assist guest to use air conditioner	$13.68
Fixed bath tap and repaired toilet roll holder	$27.35
Fixed oven	$13.68
Dry clean doona	$64.90 regularly
Dry clean blanket	$43.78 per month
Fixed loose dining table	$13.68
New knife	$20.00
Cable TV	$47.85 per month
PABX	$30.53 per month
Replace blown light bulb	$23.36
Fixed DVD player	$13.68
Pest control	$16.50 per quarter
Repaired bed wheel	$13.68
Fixed fridge and reset	$13.68
Dry clean shower curtain	$26.40 per month
Rehooked curtain	$13.68
Fixed leaking toilet	$27.35
Reset microwave oven	$13.68
Television hire	$37.00 per month
Refit towel rail	$54.00

Who cares, capital gains and tax deductions are more important than income

Many investors may consider the income to be a minor part of the expected return, especially if they realise it's only likely to be 1.5%. Residential property prices in Sydney were up 14% in the year to March 2015, so a few dollars in expenses is tolerable (although it was less than 5% per annum for the decade before 2015).

There's a problem here as well with short term letting. Most owner occupiers do not want to live in a building where the majority of other tenants are holiday-makers. These visitors are out to have a good time. They party late at night, crash their suitcases into the lifts and walls, drag their wheels across the floorboards or carpets, return from the beach in their towels and drip on the furniture. The kitchen benches get scratched, the carpet must be cleaned regularly and equipment is stolen. People who assume guests look after the room in the same way they look after their own home don't know how some people live. A permanent resident living in a building does not want to battle a lift full of suitcases every time they leave their apartment.

So the secondary market sales of these apartments are usually not to owner occupiers, and the building gradually becomes dominated by short term lets. The major buying force that pushes up the price of real estate, the person buying their dream home, is not in the market. The premises are also subject to intense wear and tear, and the foyers are full of holiday brochures and bags and screaming children and people waiting to check in or out. So these apartments are worth less than in owner occupied buildings. Investors ask to see the net return after five years, the tired furniture and dirty carpet, and the income yield is not enough to create demand unless the price is relatively low. In many locations, these apartments in hotel schemes are the cheapest in town. It's no surprise the two-bedder listed above made a large capital loss after expenses (stamp duty, agent's fees, legal fees) despite seven years of ownership.

At least the loss is a tax deduction, able to be offset against other income. But buying an asset to create a loss and a tax deduction is a strange way to build wealth. Many investors talk about the 'tax deduction benefits' as if that is a good aim in itself. The only reason it's a tax deduction is because it's a loss.

OK, but at least I can holiday there

How about justifying the purchase by using the apartment once a year for a holiday? Forget it. The time of the year when the rent is the best is also when the owner wants to use it. Don't confuse an investment with a lifestyle decision such as a holiday. Anyone who wants a week in a resort should pay for a week in a resort, not a year of problems owning the place.

Graham Hand is Editor of Firstlinks and is now onto his third sofa in an investment property. This article is for general educational purposes about a specific market segment, and individuals should obtain their own professional advice.

Disclaimer

This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.

Any general advice or 'regulated financial advice' under New Zealand law has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. For more information refer to our Financial Services Guide (AU) and Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.com.au/s/fapds.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Past performance does not necessarily indicate a financial product's future performance.

For complete details of this Disclaimer, see www.firstlinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.